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Proposal: Regulation II - Debit Card Interchange Fees and Routing
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The End of Interchange? On Dec 16, 2010, the Federal Reserve Board requested comment on proposed regulation that would "establish debit card interchange fee standards and prohibit network exclusivity arrangements and routing restrictions." The proposal is an outcome of the Dodd-Frank Act, which stipulated that interchange fees be "reasonable and proportional" to the cost incurred by debit card issuers. Under either Fed proposal, interchange would be capped at 12 cents per transaction. Today net debit interchange is around 40-45 cents. In effect, the Fed is planning to reduce interchange by at least 70%. Because most consumer who regularly use debit cards are unaware of the associated interchange fees, they find it difficult to decipher what this proposal means for them. Doing so requires an understanding of the history of interchange. History of Interchange In the 1950's, when credit cards were introduced, most people bought with either cash or checks. Regular customers with good
credit would frequently have accounts at stores, and would get a bill at the end of the month for all their purchases. Credit cards allowed people to buy stuff from more stores without having to carry cash around. They were also safer to user and more convenient than carrying checkbooks around, so consumers loved them. Merchants liked them too, since they brought in new customers who merchants otherwise wouldn't have been able to extend credit too. Of course, building this system and marketing it to customers was extremely expensive in an era when calculators were just beginning to catch on. So the credit card companies charged merchants a fee for accepting payment via a credit card: instead of getting 100% of the value of a credit card transaction, the merchant would get 95%-97%. The credit card companies also charged customers interest if they didn't pay on time, and the combination of interest and merchant discounts was enough to make the business profitable. Over time, the
industry grew and evolved. Banks got into the game and begin to issue credit

cards through associations. Credit card usage and acceptance exploded in the 1960s and 1970s to the point where they were ubiquitous. The card associations were owned by the banks, and paid them most of their share of the discount fees that they earned from the merchants, which became known as an interchange fee. Success of Debit The success of credit cards demonstrated the need for a safe and convenient alternative to cash. But it wasn't until the emergence of debit cards that card based payment became commonplace. Debit cards began as a byproduct of ATM cards in the 1980's. Because ATM usage was very popular, banks began engineering a method for customers to use ATM cards as an alternative to credit cards. Because few merchants had terminals that could accept PIN based ATM cards, debit cards were designed to work with merchant's existing credit card terminals, and to route transactions over the existing credit card network. Today, debit cards transactions are still routed through two separate payment networks---signature debit, where customers provide their signature and the transaction is routed over the credit network, and PIN debit where the customer enters their ATM PIN code and the transaction is routed over an ATM network. Regardless of how the transaction is routed to the card issuing bank, the money always comes out of a user's checking account. Debit cards also had interchange fees associated with them, just like credit cards. Initially, the interchange fee that merchants paid on debit card transactions was much lower than what they paid on credit card transactions. While cash and checks didn't have any fees associated with them, they had hidden costs. They had to be stored under lock and key to prevent them from being stolen, somebody had to deposit them at the bank, and there was always the risk of getting a bad check or counterfeit cash. Compared to the alternatives, debit cards were relatively cheap for merchants to accept. Debit cards were also available to everybody with a bank account, regardless of their credit history. Furthermore, banks loved having an additional source of revenue from card fees, especially from customers who either wouldn't or couldn't get a credit card. So everybody loved debit cards. Not surprisingly, debit card usage grew rapidly throughout the 1990's and 2000's. A whole segment of the industry, prepaid cards, came into existence to provide debit cards to people who didn't even have bank accounts. It wasn't long before most Americans had a debit card in their pocket. In 2009, debit cards overtook both credit cards and checks to become the most widely used payment mechanism in the US. However, as debit card usage grew, the industry structure changed. The card associations realized that debit was a huge growth opportunity and began to compete aggressively for customers. Most people already had cecking accounts by this time, so the associations were competing for the right to be the logo on a bank's debit card. The quickest way to win a bank over was to offer it more interchange revenue from merchants. So throughout the 90s and 00s, the associations consistently raised interchange fees charged to merchants on debit card transactions. Merchants didn't like these ever increasing fees, of course. Because most merchants had a terminal that can accept a debit or credit card with a card association logo, the associations had enormous market power. The merchants had no ability to negotiate with the associations, who up until recently were owned by the banks. The associations logically deployed their market power in the interests of their shareholders and customers, the banks. These changes were hidden from cardholders. Marketing and rewards programs persuaded customers to use cards rather than cash. The cost was paid by merchants in the form of increasing interchange fees. Even when the cost of processing declined---as payment processing switched from paper to electronic---interchange fees continued to rise. Congress to the rescue The system as it stands today is clearly broken. Banks benefit as the cost of processing decreases and interchange fees increase. With their tremendous

market power and lobbying capabilities, banks ensured that nothing much could be done about it for a long time. In this, as in many other things, the financial crisis changed everything. In the summer of 2010, Senator Dick Durbin from Illinois attached an amendment to the Dodd-Frank Act that required the Federal Reserve Board to regulate interchange fees. As soon as the banks realized what had happened, they lobbied furiously to have it removed, but the financial crisis had weakened their position. With minor exceptions for small banks, government benefits cards, and prepaid cards, the amendment became part of the final act. The Durbin amendment is clearly a flawed piece of legislation. For one thing, it
completely ignores credit interchange. Furthermore, the precedent of the Fed setting prices in a private market is troubling, and it's not something the Fed should be doing. The Fed also doesn't have complete freedom to regulate interchange, but must look only at the incremental costs of processing transactions. There is a serious risk that ham-fisted regulation will kill the flexibility and innovation that the banking world badly needs. One of the biggest dangers is rapid implementation of these new regulations, that could force the associations to rush to implement unstable and inefficient solutions in the interest of timely compliance. Another big danger is that the larger banks that are most affected by the interchange rules will use their market power to force the associations to implement a one-size-fits-all policy. This could prevent smaller banks and prepaid issuers from enjoying the full benefit of the exemptions they have from the proposed regulations How this impacts consumers The Board's proposed regulation will change the debit card industry. Interchange fees will no longer be a significant money-spinner for large banks. Because most rewards programs are funded by interchange revenue, they might disappear entirely on debit cards. To compensate, the large banks will be forced to charge higher fees to some customers, especially those who only open up a low balance checking account. Merchants should see big cost savings, running into the billions of dollars. But if the experience of Europe or Australia is any guide, little if any of this will be passed on to customers.
I applaud this outcome. The skewed structure of the current debit card industry warrants a regulatory response that evens the playing field. While this will create massive upheaval in the short-term, the industry will adapt and emerge the better for it. Further, the banking industry has become too reliant on both direct and indirect fees. Moves that reduce the industry's reliance on hidden fees and increase transparency are good for the consumer, ultimately creating a more free, and fair market.